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Nos. 85-1963 and 85-2006

SUPREME COURT
OF THE UNITED STATES

OCTOBER TERM, 1986

TYLER PIPE INDUSTRIES, INC.,
Appellant,
v.
STATE OF WASHINGTON
DEPARTMENT OF REVENUE,
Appellee.

NATIONAL CAN CORPORATION, et. al.,
Appellants,
v.
STATE OF WASHINGTON
DEPARTMENT OF REVENUE,
Appellee.

ON APPEAL FROM THE
SUPREME COURT OF WASHINGTON

BRIEF FOR APPELLEE

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QUESTIONS PRESENTED

Washington imposes a tax on the business activities of selling and manufacturing, within the state, measured by the gross proceeds derived from those activities. The tax applies at essentially the same rate and measure to (1) the in-state manufacture of goods sold elsewhere; (2) the in-state sale of goods manufactured elsewhere; and (3) the in-state sale of goods both manufactured and sold in state.

This case presents the following questions regarding that tax:

(1) May Washington impose its selling tax on goods manufactured elsewhere and sold in Washington if it also imposes its selling tax, at the same rate and measure, on goods both manufactured and sold in Washington?

(2) May Washington impose its manufacturing tax on goods manufactured in Washington and sold elsewhere if it also imposes its selling tax, at the same rate and measure as the manufacturing tax, on goods both manufactured and sold in Washington?

(3) May Washington impose its selling tax on goods manufactured elsewhere and sold in Washington and its manufacturing tax on goods manufactured in Washington and sold elsewhere, measured by the value attributable to those activities in the state, without the requirement of further apportionment?

(4) Do the selling activities of the in-state representatives of Tyler Pipe Industries, Inc. provide sufficient nexus for the imposition of Washington's gross receipts tax on its selling in the state? If so, is such nexus avoided when the activities are performed by independent contractors rather than employees?

(5) Is a tax imposed by Washington on the selling activities of a business in the state, measured by the gross proceeds from Washington sales of its products, fairly related to the services provided by the state?

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BRIEF FOR APPELLEE

STATEMENT OF THE CASE

Tyler Pipe Industries, Inc. (TPI) and National Can Corporation (NCC) challenge the validity of Washington's business and occupation (B&O) taxes paid on their business activities in Washington. We begin by briefly describing the tax and the activities of TPI and NCC (The Taxpayers), respectively.

I. WASHINGTON'S B&O TAX.

Washington's B&O tax system is broad in its sweep. The keystone for that system is Wash. Rev. Code § 82.04.220,

which levies a tax "for the act or privilege of engaging in business activities". The statutory definitions of the terms used in this provision are equally broad. Thus, Wash. Rev. Code § 82.04.150 defines "engaging in business" to include "commencing, conducting, or continuing in business and also the exercise of corporate or franchise powers". "Business" is itself broadly defined in Wash. Rev. Code § 82.04.140 to include "all activities engaged in with the object of gain, benefit, or advantage". The Washington Supreme Court has accurately summarized the effect of these provisions as imposing B&O tax "upon virtually all business activities carried on within the state." *Time Oil Co. v. State,* 79 Wn.2d 143, 146, 483 P.2d 628 (1971).

A. The Selling and Manufacturing Taxes Apply, at the Same Rate and Measure, to Separate Activities That Are Functionally Related.

The Taxpayers challenge taxes imposed on the activities of selling and manufacturing. The selling tax is imposed upon every person who makes sales in Washington, either wholesale or retail. Wash. Rev. Code §§ 82.04.270 and 82.04.250. NCC J.S. E-2, -4. The manufacturing tax is imposed upon every person engaged in business as a manufacturer in Washington. Wash. Rev. Code § 82.04.240. NCC J.S. E-2.

Although selling and manufacturing are separate categories of activities, they are functionally related. One who manufactures products either sells them or puts them to use. If they are put to use, the user avoids buying them from someone else. This functional relationship is explicitly recognized in the law. A "manufacturer" is defined as one who makes products "for sale or for commercial or industrial use". Wash. Rev. Code §§ 82.04.110 and 82.04.120.

In addition to the functional relationship between selling and manufacturing, the taxes on these activities have two common characteristics. First, the selling and manufacturing taxes have the same basic rate — .0044.[1] Wash. Rev. Code §§ 82.04.240, 82.04.250 and 82.04.270. Second, the selling and

[1]During part of the period for which NCC (but not TPI) seeks a refund, a surtax was imposed in addition to the selling and manufacturing taxes. Effective July 1, 1983 a combination of the basic rate (.0044) and the surtax for wholesaling and manufacturing taxes was .00484. The combination for retailing tax was .00471. Wash. Rev. Code §§ 82.02.030, 82.04.2901 and 82.04.2904. NCC J.S. E-1, -6.

manufacturing taxes have the same measure, that is, the same base to which the rate is applied. The measure of the selling tax is the "gross proceeds of sales" in Washington. Wash. Rev. Code §§ 82.04.250 and 82.04.270. The measure of the manufacturing tax is the "value of the products" manufactured, which is determined by the "gross proceeds derived from the sale thereof". Wash. Rev. Code §§ 82.04.240 and 82.04.450. NCC J.S. E-8.

B. The Multiple Activities Exemption Operates so That Products Manufactured or Sold in Washington Bear One B&O Tax, Manufacturing or Selling.

Although selling and manufacturing are separate categories of activities, Washington does not impose both a selling and manufacturing tax with regard to the same product. This is because of the operation of the so-called multiple activities exemption, Wash. Rev. Code § 82.04.440. NCC J.S. E-8. Under this statute "persons taxable under [retailing] or [wholesaling] shall not be taxable under [manufacturing] with respect to * * * manufacturing of the products so sold".

The key is that the multiple activities exemption only applies to products actually subject to Washington's selling tax. For example, if a business manufactures and sells a chair in Washington for $1,000 it is subject to selling tax of $4.40 ($1,000 x .0044). The multiple activities exemption exempts the business from manufacturing tax for making that chair. However, the exemption from manufacturing tax obtained by paying selling tax on one product, such as a chair, applies to no other product manufactured by the business, such as a table.

To carry the example further, if a business pays no selling tax with regard to a table made in Washington, it is liable for manufacturing tax. There are two reasons why selling tax might not be paid. First, the table might be used instead of sold. Second, the table might be sold in another state. The manufacturing tax thus due is imposed at the same rate and on the same measure as the selling tax. Accordingly, if the value of the table is $1,000, the manufacturing tax due for making the table is $4.40.

The end result of these statutes is that all products sold

or manufactured in Washington are subject to one B&O tax, either selling or manufacturing. The amount of that selling and manufacturing tax will be the same because the measure of the two taxes and the rate of the two taxes are the same.

II. TPI'S ACTIVITIES IN WASHINGTON.

TPI seeks a refund of selling taxes paid on its wholesale sales delivered to Washington customers for a 57-month period, January 1, 1976 through September 30, 1980, in the amount of $130,010. TPI J.S. B-8 FF 1.[2] The sales were of pipe and other plumbing products. These were manufactured outside of Washington by one or more of TPI's subsidiary corporations and then initially sold to TPI; TPI itself does no manufacturing. TPI Br. 4; TPI J.S. B-8 FF 2; J.A. 4, 17, 23, 36, 48, 135.

TPI receives from the State of Washington police and fire protections, the availability of the courts, and "numerous other advantages of a civilized society". TPI J.S. B-12 FF 18.

On the facts in the record, including detailed findings of fact, the Washington Supreme Court found a sufficient tax nexus between TPI's activities and Washington. TPI J.S. A-1-9. TPI, however, seeks to retry the facts by offering this Court a highly selective summary, TPI Br. 3-7, which does not truly reflect the record. Accordingly, we will describe TPI's marketing operation in Washington and three categories of functions performed by its Washington representatives.

A. TPI Markets Its Products through Sales Representatives, Either Employees or Independent Contractors, Both of Whom Perform Identical Functions.

TPI's marketing division consists of two sales departments, DWV (drainage, waste, vent) and Utility. TPI J.S. B-8 FF 2; J.A. 128-29. These departments do their local marketing across the country through sales representatives, who are either employees or, as in Washington, independent contractors. TPI J.S. B-9 FF 6; J.A. 122-23, 126-27.

[2]References to the TPI record in this section are as follows: FF refers to a Finding of Fact; RP and Ex. refer respectively to the Verbatim Report of Proceedings and individual Exhibits from the trial, in No. 85-1963.

There are no significant differences in authority and functions between the employee and contractor representatives. TPI J.S. B-11 FF 12; J.A. 61-62, 87, 124, 126-27. Both types are directed, supervised, and instructed by TPI personnel. TPI J.S. B-9 FF 5; J.A. 131-32, 134. Both the employees and contractors are paid on commission; the employees, however, receive insurance benefits and the contractors receive a little higher commission rate. J.A. 122-27. The contractor representatives are TPI's agents. J.A. 110. They do not handle any competing product lines, although they do also represent other non-competing companies. J.A. 95, 100, 152. When TPI asks them to do something, they do it. J.A. 90, 107.

For most of Washington, TPI utilizes two independent contractors. Representative Ashe & Jones performs virtually all of the sales functions in its territory for all TPI products, except those of TPI subsidiary Wade, Inc.[3] TPI J.S. B-8-9 FF 3, 6; J.A. 48-49, 137. Ashe & Jones employs "three and a half" sales people. J.A. 102. Its territory is principally the State of Washington, with half of its customers being located in Western Washington. J.A. 29, 107. During the relevant 57-month period, Ashe & Jones was involved in $22,345,110 worth of TPI Washington sales. J.A. 139. Ashe & Jones receives a commission for every TPI sale made in its territory, even if the customer forwards its order directly to TPI rather than through the representative. TPI J.S. B-9 FF 6; J.A. 97, 139. Ashe & Jones represents both the DWV and Utility departments, and its commissions are calculated on the basis of both DWV and Utility sales. TPI J.S. B-8 FF 3; J.A. 110; RP 245. Ashe & Jones pays B&O tax measured only by the sales commissions it receives. J.A. 98-99.

During the relevant 57-month period, TPI sent five of its officers or employees into Washington (one of them six times), to provide liaison with its sales representatives, for routine goodwill promotion, to attend a regional trade show, and to

[3]The second contractor representative, Mechanical Agents, Inc., represents Wade, Inc., a wholly-owned subsidiary of TPI which markets specification drainage products. Mechanical Agents maintains an inventory of Wade products (owned by TPI/Wade) in its Seattle warehouse. TPI J.S. B-9 FF 4. Mechanical Agents employs four sales people who engage in numerous Washington activities on Wade's behalf. J.A. 113-14; RP 340. TPI is no longer contesting the taxes measured by Wade sales. TPI J.S. B-8 FF 1.

provide customer service. Ex. 14, RP 2, 85. TPI provides other assistance to its representatives also, such as in handling customer problems, calling on contractors and engineers, and closing orders. TPI J.S. B-9 FF 5; J.A. 131, 133-34.

B. TPI's Sales Representatives Regularly Provide Virtually All of TPI's Information about the Washington Market.

Washington sales representatives provide virtually all of the Washington market information obtained by TPI. This information, provided on a regular, timely basis,[4] is necessary to keep TPI competitive in the marketplace. TPI J.S. B-9-10 FF 8; J.A. 50, 124-25, 143-44. It helps TPI to complete its national picture. J.A. 67.

Ashe & Jones provides both specific and general market information. Specific information is provided about competitors' products, pricing, and activities. TPI J.S. B-10 FF 8; J.A. 49, 68, 88, 101, 104; *cf.* Ex. 50, RP 299, 300. Ashe & Jones reports on existing and potential new customers, customer financial reliability, and any special financial or other risks involved in potential sales. TPI J.S. B-10 FF 8; J.A. 84-86, 120-21, 148, 153. Information is also provided to keep TPI abreast of competitive and market conditions and business activity in general. This includes vital feedback about market trends, construction activity, "bellwether" contractors, prospective orders, product performance, and personnel and ownership changes in the trade. TPI J.S. B-10 FF 8; J.A. 49, 50-51, 55, 68, 95, 99, 102.

C. TPI's Sales Representatives Solicit and Process Orders from Washington Customers.

TPI's sales representatives regularly call on the trade for TPI to promote sales and solicit orders from wholesalers. TPI J.S. B-10 FF 9; J.A. 55, 103, 146. They also regularly receive specific orders and transmit them to TPI. TPI J.S. B-10 FF 9;

[4]Ashe & Jones personnel communicate by telephone with TPI personnel about a dozen times a week, including communications "quite often" (about 3 to 5 times a week) with the Utility department in particular. RP 255-56, 276-80. These communications are used to convey to both the DWV and Utility departments the described market information obtained from calls on the trade and to transmit and coordinate specific orders. J.A. 55, 68, 99-101, 107.

J.A. 96, 162. Ashe & Jones talks to TPI's DWV order desk approximately 2 or 3 times a week to place orders, and to its Utility order desk about once every other week. RP 275-76, 278.[5]

During the relevant period, Ashe & Jones transmitted to TPI 55.04% of TPI's total orders from Washington customers (excluding Wade). Stated another way, Ashe & Jones transmitted no Utility orders but 98% of the remaining non-Wade orders. J.A. 162.[6] TPI did not reject any order transmitted by a Washington sales representative. TPI J.S. B-11 FF 13; J.A. 150.

D. TPI's Sales Representatives Develop and Maintain the Washington Market for TPI Products.

Ashe & Jones personnel generate future orders by spending a significant part of their time making "secondary calls" to persuade Washington engineers, architects, and contractors (the customers of TPI's customers) to specify and use both DWV and Utility products in their projects. TPI J.S. B-10 FF 10; J.A. 55, 102-03. Sometimes these calls are in response to inquiries triggered by advertising. J.A. 58. The representative provides price quotations of TPI products for specific construction projects. TPI J.S. B-10 FF 10; J.A. 47-48, 132, 146. These secondary calls help to maintain TPI's relationships with the engineers and contractors. J.A. 109.

After an order has been placed, the sales representative has a follow-up role. If a Washington customer has a problem with shortages, non-conforming goods, or the amount of an invoice, that customer generally contacts TPI's local sales representative, who will participate in investigating and handling any adjustment. TPI J.S. B-10 FF 10; J.A. 59, 106. These contacts, about both DWV and Utility products, are made with Ashe & Jones about 10 to 12 times a year. J.A. 88-89, 92, 104-06.

[5]Although Ashe & Jones does not usually transmit Utility orders, it calls the Utility order desk for the purpose of coordinating Utility and DWV shipments. RP 278-79.

[6]Transmitted non-Utility non-Wade orders (4,588) divided by total non-Utility non-Wade orders (4,683) equals .979. J.A. 162.

The sales representative performs still other important services for TPI. TPI requires the sales representative to serve as the first line evaluator of a potential new customer's financial responsibility. J.A. 153 ¶ 4. The representative may make inquiries for TPI regarding late payments. TPI J.S. B-10-11 FF 10; J.A. 115, 118-19. A representative also makes other communications on TPI's behalf, such as providing counteracting sales information about specific competing products and calling on plumbing inspectors and plumbing code authorities. TPI J.S. B-10 FF 10; J.A. 55; RP 301-02; Ex. 50, RP 299, 300.

TPI's sales representatives have long-established and valuable relationships with its customers and with engineers, architects, and contractors in the trade. TPI J.S. B-9 FF 7; J.A. 103. Through their sales contacts, the representatives "keep the door open for further transactions", reminding wholesalers and others that TPI is actively soliciting their DWV and Utility business. J.A. 55, 87. The representatives maintain and improve TPI's name recognition, market share, goodwill, and customer relations. TPI J.S. B-9 FF 7; J.A. 58, 110, 149. The sales representatives are involved in *all* TPI Washington sales transactions, either actively or at least in the sense of being present, aware of the transactions, and available to assist if necessary. The sales representatives afford to TPI's customers the "presence" of TPI, because they are "there to be of benefit to the wholesaler at whatever point possible." TPI J.S. B-11 FF 11; J.A. 56.

III. NCC'S ACTIVITIES IN WASHINGTON.

NCC sells packaging products in Washington and throughout the world. These products are manufactured in twenty-two states including Washington. J.A. 178 ¶¶ 2, 3. In Washington NCC employs approximately 240 people with a payroll in 1983 of approximately $7.6 million. J.A. 179 ¶ 6. These employees are involved in the manufacture of products at the two plants located in this state. This number also includes NCC's Washington sales office. J.A. 179-80 ¶¶ 6-8.

During the period January 1, 1980 through December 31, 1984 NCC was subject to taxes on its selling and manufacturing activities in Washington. NCC paid selling tax (wholesaling) of $606,863 on the sales of products in Washington that were manufactured elsewhere. J.A. 180 ¶ 9. This selling tax was measured by the gross proceeds of sales which ranged from $19.9 million to $32 million between 1981 and 1984. J.A. 180 ¶ 9. In contrast, NCC's worldwide sales in 1983 were approximately $1.552 billion. J.A. 181 ¶ 13.

NCC also paid manufacturing tax of $372,843 on products manufactured in Washington and sold elsewhere. J.A. 180 ¶ 10. This manufacturing tax was measured by the value of the products, as determined by their sales price, which ranged from $11.3 million to $18.7 million between 1981 and 1984. J.A. 180 ¶ 10. NCC challenges the imposition of both the selling and manufacturing taxes.

SUMMARY OF ARGUMENT

1. The one common, and in our view most important, issue is The Taxpayers' claim that Washington's B&O tax discriminates against their selling and manufacturing activities conducted within Washington. This appeal calls upon the Court once again to test such discrimination claims under the Commerce Clause parameters which govern interstate businesses and the states.

In early Commerce Clause cases, the Court observed that a case-by-case approach provided "little in the way of precise guides to the States in the exercise of their indispensable power of taxation." *See e.g., Northwestern States Portland Cement Co. v. Minnesota,* 358 U.S. 450, 457 (1959). Recently, however, the Court has identified a clear, workable "bright line" test which draws the line between (1) a system which discriminates against interstate commerce, and (2) a system which fairly encourages in-state business.

In *Boston Stock Exchange v. State Tax Commission,* 429 U.S. 318, 329, 336-37 (1977), the Court clearly set out those parameters when it contrasted tax systems which "encourage the growth and development of intrastate commerce and industry" and "compete with other states for a share of interstate commerce" with those which discriminate "by providing a direct commercial advantage to local business."

Under the test a state tax system, viewed as a whole, may neither erect barriers to the flow of goods and services into a state, nor provide inducements to a taxpayer, in the form of

reduced tax burdens, to increase its business activity within a state. These two effects are simply different sides of the same coin. If, by avoiding these consequences, the system allows to the taxpayer tax neutral decision-making, then that system is not discriminatory.

Armco, Inc. v. Hardesty, 467 U.S. 638 (1984) is in harmony with this test. Washington's challenged tax system meets the test for nondiscrimination and is thus distinguishable from the West Virginia statute invalidated in *Armco.* Nevertheless, The Taxpayers seize upon unessential language in *Armco,* dealing with concepts of compensating taxes and the internal consistency of tax systems, to argue for a different result. The Taxpayers fail, however, to deal with this Court's articulated test for discrimination. The Taxpayers would jettison the bright line test, but offer no substitution that accommodates the interests of taxing states and interstate businesses consistent with the Court's prior rulings.

2. Initially, the source and scope of the discrimination claim must be examined. Washington's tax applies to (1) businesses that manufacture within the state, (2) businesses that sell within the state, and (3) businesses that do both. The Taxpayers' discrimination claim addresses the treatment given to those businesses that conduct *both* activities within the state *with respect to the same products.* In Washington, such businesses are involved in two different sorts of business activities, but are taxed only once on the totality of in-state business activity. The Taxpayers claim that Washington discriminated when it elected to impose only one tax because two functional activities are involved in that totality. Their claim has two aspects.

The Taxpayers, representing both Washington manufacturers selling outside the state and out-of-state manufacturers selling within the state (who both pay only one Washington tax), argue that Washington's law discriminates. They argue *Armco* requires internal consistency and if other states had Washington's system, taxes would be doubled up on the interstate level but not on the intrastate level. They argue this requires striking down *both* the manufacturing tax and the selling tax.

The Taxpayers also argue Washington's tax discriminates because businesses which manufacture in state but sell out of

state pay under a manufacturing classification and those businesses which both manufacture and sell in state pay only under a selling classification pursuant to Wash. Rev. Code § 82.04.440, the multiple activities exemption. The measure and rate of the tax is identical under both classifications. The Taxpayers argue this tax, paid under the selling classification, is irrelevant because taxes on selling and manufacturing can *never* be complementary.

3. First, we apply the bright line test to each tax classification. Washington's selling tax, challenged in both cases, meets the bright line test because *all* sellers pay that tax. The same rate and the same base always apply. The tax erects no barrier to goods coming into the state and provides no inducement to taxpayers, in the form of a reduced tax burden, to move manufacturing operations into the state. *Armco* is not applicable because it involved a selling tax which did not apply to all sellers, but instead completely excluded in-state manufacturers.

A taxpayer subject to Washington's selling tax is never subject to Washington's manufacturing tax for the goods it sells in Washington, whether those goods be manufactured in Washington or elsewhere. Where the taxpayer locates its manufacturing operations has absolutely no effect on that taxpayer's tax. Such tax neutral decision-making is exactly the type of fair encouragement which this Court has approved.

Additionally, TPI's challenge to the selling tax is without merit because TPI is solely a seller, not a manufacturer. It buys the products it sells from separate subsidiaries.

4. The manufacturing tax, which is involved only in *NCC,* is not discriminatory; for taken together with the selling tax, it too allows for tax neutral decision-making. The two taxes combined neither erect a barrier to goods or services flowing into the state nor provide the prohibited inducement to the taxpayer to increase business operations within the state. For this reason, the manufacturing tax should be considered a permissible compensating tax.

The Court's prior compensating tax decisions, including *Maryland v. Louisiana,* 451 U.S. 725 (1981) on which The Taxpayers also rely, are consistent with the test we here invoke. Under those cases, the bright line (*i.e.,* "tax neutral decision-making") test is the test actually applied to determine

whether a tax is a compensating tax. Nor is *Armco* to the contrary. *Armco* did not hold, as NCC argues, that taxes on manufacturing and selling can *never* be compensatory to each other. *Armco* simply held that West Virginia, by providing different rates and measures for the two taxes, did not actually treat them as compensatory. Because the measure for the manufacturing tax could be reduced well below that for the selling tax, the West Virginia system shared the same vice as the tax systems found defective in *Boston Stock Exchange* and *Maryland v. Louisiana.* Further, NCC's overly broad reading of *Armco* is contrary to *Hinson v. Lott,* 8 Wall. 148 (1869) where a manufacturing tax was treated as compensatory to a related selling tax. To adopt NCC's reading of *Armco* results in a conceptual quagmire. Instead of the workable test which this Court has previously developed and utilized, and upon which we rely, NCC proposes a metaphysical examination into whether the events being taxed are "substantially equivalent". NCC offers no guides as to what constitutes either equivalency or substantiality under that kind of examination.

5. NCC's argument that even if the manufacturing tax is considered a compensating tax, the principle of internal consistency in *Armco* requires invalidation, is wrong. It reads *Armco* too broadly, is not supported by *Armco*'s actual language, and would render invalid compensating taxes which have previously been held valid in *Hinson* and *Southern Pacific Co. v. Gallagher,* 306 U.S. 161 (1939). That reading would invalidate as well Washington's selling tax, which presents no compensating tax issue.

The internal consistency issue is: if State A refuses to double tax the same item — for example, by foregoing the use tax if it has imposed a sales tax — must it extend like treatment to State B's sales tax through a credit or other offset? The Court has consistently refused to resolve that question. *See Henneford v. Silas Mason Co.,* 300 U.S. 577 (1937); *Southern Pacific;* and *Williams v. Vermont,* 472 U.S. ___, 105 S.Ct. 2465 (1985), a post-*Armco* case. This demonstrates that the Court's discussion in *Armco* was not intended to resolve it.

NCC's argument in support of its claim of discrimination is fundamentally flawed because, if accepted, it would result in

preferential treatment for NCC over local taxpayers. NCC seeks relief from the Washington tax on manufacturing even if it pays no tax at all on its selling activities in another state. This is hardly a claim for equal treatment with local taxpayers, who must always pay a tax.

6. Washington's tax satisfies the apportionment prong of the Commerce Clause test because it has long been settled that a state may impose (1) a tax on in-state manufacturing, measured by the gross sales of the goods so manufactured; and (2) a tax on in-state selling activities, measured by the gross sales to in-state customers generated by those activities. Further, as *Armco* confirmed, the state of manufacture and the state of sale may each impose its tax, each using the same gross proceeds as the measure; one state need not defer to the other. For both types of taxes, the requirement of fair apportionment means only that the gross proceeds used as the measure must be fairly related to the in-state activities. Contrary to the claims of The Taxpayers and *amicus* Amcord, no further diminution of the measure of the tax is required.

7. TPI clearly satisfies the nexus requirement, as found by the trial court, because TPI's sales representative in Washington, Ashe & Jones, engaged in substantial activities including gathering market information, solicitation, and market maintenance. The fact that this representative is not formally an employee, but an independent contractor, makes no difference under the rationale of *Scripto, Inc. v. Carson,* 362 U.S. 207 (1960). This contractor representative functions and is compensated in essentially the same manner as TPI's employee representatives elsewhere. TPI's further claim that the tax is not fairly related to benefits provided by the state presents no issue separate from the nexus claim, and is essentially groundless.

8. Should the Court reverse the decisions below on either the discrimination issue or the apportionment issue, such a result would constitute a significant change from the Court's prior decisions, and the Court accordingly should apply its ruling prospectively only. If, however, the Court should decide that its ruling should be applied retroactively, further remedial issues arise which, because they are so intertwined with issues of state law, should be remanded to the court below for resolution.

ARGUMENT

I. SUMMARY OF THE TAXPAYERS' CONSTITUTIONAL CLAIMS.

This case involves challenges to Washington's B&O tax under both the Commerce Clause, art. I, § 8, cl. 3, and Due Process Clause, amend. XIV, § 1, of the United States Constitution. In *Complete Auto Transit, Inc. v. Brady,* 430 U.S. 274, 279 (1977) the Court laid down four tests for assessing the Commerce Clause validity of a state tax: (1) there must be a sufficient connection or nexus between the interstate activities and the taxing state; (2) the tax must not discriminate against interstate commerce; (3) the tax must be fairly apportioned; and (4) the tax must be fairly related to the services provided by the state.

The Due Process Clause sets forth two additional tests: (1) there must be a minimal connection between the interstate activities and the taxing state; and (2) there must be a rational relationship between the income attributed to the state and the intrastate values of the enterprise. *Mobil Oil Corp. v. Commissioner of Taxes of Vermont,* 445 U.S. 425, 436-37 (1980). The Court has recognized that the Commerce Clause and Due Process Clause tests in the area of state taxation are similar. *National Bellas Hess, Inc. v. Department of Revenue of the State of Illinois,* 386 U.S. 753, 756 (1967).

To invalidate a state's tax, taxpayers must show that the challenged statute contravenes these standards. The Taxpayers both claim that the B&O tax violates the discrimination and fair apportionment prongs of the *Complete Auto* test. We will address these common claims first. We will then address the claims by TPI, under the Commerce and Due Process Clauses, that there is insufficient nexus for Washington to impose its tax and that the tax is not fairly related to the services provided by the state.

II. THE SELLING AND MANUFACTURING TAXES DO NOT DISCRIMINATE AGAINST INTERSTATE COMMERCE.

A. The Discrimination Prong of the Complete Auto Test Prohibits Discrimination while Permitting Fair Encouragement.

The discrimination test embodies two basic principles. First, a state is prohibited from imposing a tax "which discriminates against interstate commerce * * * by providing a direct commercial advantage to local business." *Boston Stock Exchange v. State Tax Commission,* 429 U.S. 318, 329 (1977). The second principle is the converse of the first. A state may structure its tax system "to encourage the growth and development of intrastate commerce or industry" or to "compete with other States for a share of interstate commerce" so long as it does not "discriminatorily tax the products manufactured or the business operations performed in any other State." *Boston Stock Exchange,* 429 U.S. at 336-37.

The line between the discrimination principle and the fair encouragement principle is simply this: A state tax law discriminates if it affects the direction of commerce, either by erecting barriers or by allowing an interstate business, already subject to a state's taxes, to *reduce* its tax burden in the state by *increasing* its business operations there. A state tax law constitutes fair encouragement when it treats local business and interstate commerce equally, allowing for tax neutral decision-making with regard to the direction of commerce.

The key is tax neutral decision-making with regard to the direction of commerce. Our discussion will focus on the Court's decisions establishing this proposition.

1. A tax discriminates if it erects barriers or induces nonresidents to increase their business within the state.

The Court has identified two kinds of taxes that affect the direction of interstate commerce and are thus discriminatory. The first seeks to protect local business by erecting a barrier against the flow of goods in interstate commerce. For example, in *Bacchus Imports, Ltd. v. Dias,* 468 U.S. 263 (1984), the Court struck down an excise tax on the sale of liquor because certain locally produced liquor was exempt from the tax. The result was a tax on interstate commerce but not on local business. This constituted a barrier against interstate commerce which provided a direct commercial advantage to local business.

The second type of discriminatory tax is not designed as a barrier. It seeks instead to induce an interstate business, al-

ready subject to the state's tax, to increase business activity within the state. This inducement is brought about by allowing an interstate business to *reduce* its tax burden, in the taxing state, by *increasing* its business operations there. For example, in *Westinghouse Electric Corp. v. Tully,* 466 U.S. 388 (1984) the interstate taxpayer was subject to New York's franchise tax. The tax could be reduced by the application of a credit and the amount of the credit increased as a business increased its percentage of shipping from New York ports. The Court struck down the credit because it *reduced* the business' New York tax burden, *e.g.*, from $420 to $406, if the business *increased* its percentage of shipping out of New York from zero to one hundred percent. 466 U.S. at 400 n. 9 (Table A). The Court concluded that the tax was discriminatory because it foreclosed tax neutral decisions by inducing business into New York. In the words of the Court:

> Whether the discriminatory tax diverts new business into the State or merely prevents current business from being diverted elsewhere, *it is still a discriminatory tax that "forecloses tax-neutral decisions* and * * * creates * * * an advantage" for firms operating in New York by placing "a discriminatory burden on commerce to its sister States". *Boston Stock Exchange,* 429 U.S., at 331.

466 U. S. at 406 (emphasis added).

The economic operation of the discriminatory taxes in *Bacchus* and *Westinghouse* is essentially the same. To avoid a barrier an interstate business must become a local business. Thus, an interstate business could avoid the barrier set up in *Bacchus* by moving its operation into Hawaii and qualifying for the exemption given to local business. In this way it would *increase* its business in Hawaii, while at the same time *reducing* its Hawaii tax burden.

2. Fair encouragement exists when local and interstate commerce are treated equally, allowing for tax neutral decision-making.

A state tax law constitutes fair encouragement instead of discrimination when it treats local and interstate commerce equally, allowing for tax neutral decision-making with regard to the direction of commerce. This distinction was explicitly recognized in *Boston Stock Exchange,* 429 U.S. 318 (1977)

which concerned the New York tax on stock transfers. The tax was imposed on five separate taxable events, including sales and transfer of securities. The tax applied if any one of these five events, *e.g.*, transfer, occurred in New York even if other events, *e.g.*, sale, took place in another state. However, if more than one event, *e.g.*, both sale and transfer, occurred in New York, only one tax was payable on the entire transaction. 429 U.S. at 321-22.

Prior to the 1968 amendments the amount of the tax was the same wherever the sale took place. The 1968 amendments reduced the tax but only for those selling stock in New York, *e.g.*, 30,000 shares selling at $20 per share would be subject to a maximum tax of $350 if both sold and transferred in New York and a tax of $1,500 if transferred in New York and sold elsewhere. 429 U.S. at 334. The Court struck down the 1968 amendment because "the choice of exchange * * * is not made solely on the basis of nontax criteria. Because of the * * * transfer in New York, the seller cannot escape tax liability by selling out of State, but he can substantially reduce his liability by selling in State." 429 U.S. at 331.

In dicta, the Court contrasted the discriminatory amendments with the pre-1968 tax which did not have this vice. The pre-1968 tax was neutral because:

> [*The tax*] *fell equally on all transactions regardless of the situs* of the sale. Thus, the choice of an exchange for the sale of securities that would be transferred * * * in New York was not influenced by the transfer tax; wherever the sale was made, tax liability would arise. *The flow of interstate commerce in securities was channeled neither into nor out of New York by the state tax.*

429 U.S. at 330 (emphasis added).

These decisions establish a bright line test for judging discrimination. Taxes that affect the flow of interstate commerce are discriminatory. Neutral taxes are not.

B. The Selling Tax Is Not Discriminatory because It Allows Tax Neutral Decision-Making.

The Taxpayers claim that the selling tax discriminates against interstate commerce. TPI Br. 14-17; NCC Br. 7-10. The selling tax has been sustained by the Court on three pre-

vious occasions. *General Motors Corp. v. Washington,* 377 U.S. 436 (1964); *Standard Pressed Steel Co. v. Department of Revenue of Washington,* 419 U.S. 560 (1975); *Chicago Bridge & Iron Co. v. Washington Department of Revenue,* 98 Wn.2d 814, 659 P.2d 463 (1983), *appeal dism'd,* 464 U.S. 1013 (1983). This time The Taxpayers' challenge is based primarily on *Maryland v. Louisiana,* 451 U.S. 725 (1981), although TPI also invokes *Armco, Inc. v. Hardesty,* 467 U.S. 638 (1984).

Our analysis of The Taxpayers' claim focuses on the test for discrimination. We will demonstrate that the selling tax does not create a barrier, as was the case in *Armco,* or entice interstate commerce into the state with reduced taxes, as was the case in *Maryland v. Louisiana.* The selling tax does not discriminate because it treats local and interstate commerce equally, allowing for tax neutral decision-making with regard to the direction of commerce.

1. The selling tax does not create a barrier or violate Armco because all sellers pay it.

The selling tax does not create a barrier and is not covered by *Armco,* 467 U.S. 638 (1984). In *Armco* the Court invalidated West Virginia's wholesaling tax. The flaw in the tax was that it applied *only* to sales in interstate commerce. The Court struck down the tax because "a State may not tax a transaction or incident more heavily when it crosses state lines than when it occurs entirely within the State." 467 U.S. at 642.

Washington's selling tax is not similarly flawed because it applies to *all* sales in this state. Goods manufactured in Washington and sold here are subject to selling tax and so are goods manufactured elsewhere and sold here. Washington does not tax a sales transaction more heavily when it crosses state lines.

2. An out-of-state manufacturer cannot reduce its Washington tax by manufacturing here.

The Taxpayers' main complaint with regard to the selling tax focuses on the operation of the multiple activities exemption, Wash. Rev. Code § 82.04.440, which provides that persons subject to selling tax are exempt from manufacturing tax *with respect to the product so sold.* The gravamen of their argument is that "local business is awarded an exemption from the manufacturing tax. Out-of-state manufacturers receive no comparable benefit." NCC Br. 8.

The Taxpayers' argument is frivolous. An out-of-state manufacturer, selling here, is *also* exempt from Washington's manufacturing tax, because its manufacturing activity does not take place "within this state". Wash. Rev. Code § 82.04.240. In essence The Taxpayers claim they do not receive an exemption from a manufacturing tax they never have to pay.

The selling tax and multiple activities exemption do not discriminate by enticing business into Washington, because an interstate business cannot *reduce* its tax burden in Washington by *increasing* its business here. An out-of-state manufacturer selling in Washington cannot reduce its Washington taxes by moving its manufacturing operation into this state. For example, a business that manufactures $1,000 of goods elsewhere and sells them in Washington pays a selling tax of $4.40 ($1,000 x .0044). The business pays precisely the same amount of selling tax, $4.40, if it moves its manufacturing operations into Washington and both manufactures and sells in this state. In neither case is the business subject to Washington manufacturing tax. Thus, the selling tax does not violate the test for discrimination laid down by the Court.

The Taxpayers try to show discrimination by comparing the business activities of local and interstate commerce without regard to the Washington tax their *goods* must bear. TPI Br. 15-16; NCC Br. 10. The Taxpayers' argument is simply this: A local business that both manufactures and sells a chair in Washington for $1,000 engages in two business activities in this state (selling and manufacturing) and pays a selling tax of $4.40. An interstate business that manufactures a chair elsewhere and sells it in Washington for $1,000 engages in one business activity in Washington (selling) and pays a selling tax of $4.40. The Taxpayers allege that Washington's system is discriminatory because a local business can engage in two business activities for the price of one.

The flaw in The Taxpayers' activity analysis is that it ignores the test for discrimination laid down by the Court. The Court has consistently looked to the "practical operation" of the tax to determine if it discriminated against interstate commerce. *Halliburton Oil Well Cementing Co. v. Reily,* 373 U.S. 64, 69 (1963). Thus, the Court has consistently judged discrimination based on the relative tax burdens imposed on the

products of local and interstate commerce, even when the taxes are imposed on privileges relating to those products, as in this case.

For example, in *Henneford v. Silas Mason Co.*, 300 U.S. 577 (1937) the Court considered the validity of Washington's use tax. Under the statute Washington imposed a tax on retail sales and a use tax for the privilege of using, within this state, any article of tangible personal property. The law also contained a provision similar to the multiple activities exemption which provided that use tax was not due if retail sales tax was paid. As in this case, the sales and use taxes were imposed on privileges. If one focuses solely on the activities, the sales and use taxes allow two for the price of one. Thus, a person buying a product locally engages in two taxable privileges, sales and use, but pays only retail sales tax. A person who buys elsewhere and brings a product into Washington engages in only one taxable privilege, use, but pays precisely the same tax.

The Court in *Silas Mason* sustained the imposition of use tax. It did not focus on the activities. Instead, the Court looked to the relative tax burden imposed on the goods.

> When the account is made up, the stranger from afar is subject to no greater burdens as a consequence of ownership than the dweller within the gates. *The one pays upon one activity or incident, and the other upon another, but the sum is the same when the reckoning is closed.*

300 U.S. at 584 (emphasis added).

Thus, focusing on activities does not demonstrate discrimination. The question is whether the practical operation of the tax establishes barriers or entices business into the state. Based on this test Washington's so-called "two for one" does not discriminate.

TPI's reliance on the "two for one" argument is particularly misplaced, since TPI is not a manufacturer. Products sold by TPI in Washington are manufactured by separate corporations, Tyler Pipe Industries of Texas, Inc. and Tyler Plastics Co. J.A. 135; TPI Br. 4. Even if TPI moved into Washington it would never be subject to a manufacturing tax, because it does not engage in any manufacturing activity. Thus, even if the Court concluded that the selling tax did discriminate against out-of-state manufacturers, that conclu-

sion would have no application to TPI.

Unlike the tax in *Bacchus*, 468 U.S. 263 (1984), the selling tax does not impose a barrier to interstate commerce because it is imposed on interstate and local sales alike. Unlike the taxes in *Westinghouse*, 466 U.S. 388 (1984) and *Boston Stock Exchange*, 429 U.S. 318 (1977), the tax provides no incentive for an interstate manufacturer, that sells in Washington, to move its manufacturing operation into this state — because the total Washington tax due will remain exactly the same. Thus, Washington's selling tax does not discriminate against interstate commerce. The tax treats local business and interstate commerce equally, allowing for tax neutral decision-making with regard to the direction of commerce.

3. Maryland v. Louisiana is distinguishable because a business could reduce its Louisiana tax by increasing its Louisiana business.

The Taxpayers argue that the multiple activities exemption discriminates against interstate commerce in the same way as the first use tax credit struck down in *Maryland v. Louisiana*, 451 U.S. 725 (1981). TPI Br. 16; NCC Br. 7-9. The first use tax was imposed on natural gas brought into Louisiana from the Outer Continental Shelf (OCS). Louisiana also imposed a severance tax on gas severed in Louisiana. The law provided that "an owner paying the First-Use Tax on OCS gas receives an equivalent tax credit on *any* state severance tax owed in connection with production in Louisiana." 451 U.S. at 756 (emphasis added). Thus, the credit received for paying first use tax on *OCS gas* could be applied to reduce severance tax that would otherwise be due on gas severed in Louisiana (*non-OCS*). The Court found the credit discriminatory, as it encouraged "natural gas owners involved in the production of OCS gas to invest in mineral exploration and development within Louisiana". 451 U.S. at 757. The economic incentive was that a business could *reduce* its Louisiana tax burden, *e.g.*, from \$70 to \$35 if it *increased* its business in Louisiana. 451 U.S. at 757 n. 28.

This is the same reason the Court struck down the taxes in *Boston Stock Exchange*, 429 U.S. 318 (1977) and *Westinghouse*, 466 U.S. 388 (1984). In each of these three cases the law was discriminatory because taxes could be *reduced*, in the

taxing state, by *increasing* business there.

The multiple activities exemption does not have this flaw. The credit in *Maryland v. Louisiana* and the multiple activities exemption differ significantly in that the multiple activities exemption only applies to products which have been subjected to selling tax. Thus, selling tax paid on the sale of a chair provides a manufacturing tax exemption on making the chair. It applies to no other product, such as a table. *See Crown Zellerbach Corp. v. State,* 45 Wn.2d 749, 756, 278 P.2d 305 (1954). As a result, the multiple activities exemption does not result in reduced Washington tax. In contrast, in *Maryland v. Louisiana* the first use tax on OCS gas was applied to a completely different product, non-OCS gas. The credit reduced taxes in Louisiana by lowering or eliminating a severance tax which would otherwise be paid.

C. The Manufacturing Tax Is Not Discriminatory, since It Complements the Selling Tax; Both Taxes Apply Equally to Commerce, Allowing Tax Neutral Decision-Making.

NCC also challenges the imposition of manufacturing tax on goods it manufactures in Washington and sells elsewhere. Since the goods are sold elsewhere, there is no selling tax paid on the sale and the multiple activities exemption does not operate. NCC contends that the manufacturing tax thus imposed violates the discrimination prong of the *Complete Auto* test. NCC Br. 5-7. For NCC's contention to have merit one must view the manufacturing tax in isolation without reference to the selling tax.

We agree that *if* the manufacturing tax stood alone it would be discriminatory because it applies primarily to interstate commerce. However, the manufacturing tax does not stand alone. As we have seen, a Washington manufacturer who sells here is subject to selling tax. The Court has long recognized that a tax imposed primarily on interstate commerce is not discriminatory if it compensates for a tax imposed on local commerce.[7]

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[7] See Hellerstein, *Complementary Taxes as a Defense to Unconstitutional State Tax Discrimination,* 39 Tax Lawyer 405 (1986), which provides an extended view of the development of the law in this area. However, the author's proposed criteria for compensating taxes depart radically from criteria laid down by the Court.

The Court's seminal compensating tax decision, *Silas Mason,* 300 U.S. 577 (1937) illustrates the reason compensating taxes are not discriminatory. In *Silas Mason,* the Court addressed Washington's use tax and compared it to Washington's retail sales tax. The rate and measure of these two taxes were the same. Washington law also exempted from the use tax goods subject to retail sales tax. 300 U.S. at 579-81. As a result, the use tax applied primarily to goods purchased out of state and brought into Washington. The Court ruled there was no discrimination because:

> Equality exists when the chattel subjected to the use tax is bought in another state and then carried into Washington. It exists when the imported chattel is shipped from the state of origin under an order received directly from the state of destination. In each situation the burden borne by the owner is balanced by an equal burden where the sale is strictly local.

300 U.S. at 584.

Thus, compensating taxes do not discriminate because, when the two taxes are considered together, local business and interstate commerce are treated equally, allowing for tax neutral decision-making. As the Court said in *Boston Stock Exchange,* 429 U.S. 318, 332 (1977):

> In all the use tax cases, *an individual faced with the choice of an in-state or out-of-state purchase could make that choice without regard to the tax consequences.* If he purchased in State, he paid a sales tax; if he purchased out of State but carried the article back for use in State, he paid a use tax of the same amount. The taxes treated both transactions in the same manner. (Emphasis added.)

With this background, we begin our analysis by explaining the criteria for establishing a compensating tax. We will then focus on NCC's lone argument that the manufacturing tax is not a compensating tax. Finally, we will demonstrate that the manufacturing tax meets the compensating tax criteria laid down by the Court.

1. Compensating taxes must be designed to achieve equality and actually result in equal treatment of local and interstate commerce.

"The common thread running through the cases uphold-

ing compensatory taxes is the equality of treatment between local and interstate commerce." *Maryland v. Louisiana*, 451 U.S. 725, 759 (1981). This equality exists if the two taxes being compared are designed to achieve equality *and* actually result in equal treatment of in-state and out-of-state taxpayers similarly situated. Taxes that do not meet both criteria are not compensating taxes.

For example, in *Maryland v. Louisiana*, the first use tax and severance tax were not designed to achieve equality. Although the rate and measure of the two taxes were the same:

> [T]he pattern of credits and exemptions allowed under the Louisiana statute undeniably violates this principle of equality. As we have said, OCS gas may generally be consumed in Louisiana without the burden of the First-Use Tax. Its principle application is to gas moving out of the State. Of course, it does equalize the tax burdens on OCS gas leaving the State and Louisiana gas going into the interstate market. But this sort of equalization is not the kind of "compensating" effect that our cases have recognized.

451 U.S. at 759.

Even two taxes designed to achieve equality are not compensating taxes unless they actually result in equal treatment of local and interstate commerce. For example, in *Halliburton*, 373 U.S. 64 (1963), the Court struck down Louisiana's use tax even though the state also imposed a retail sales tax in the same pattern approved in *Silas Mason*, 300 U.S. 577 (1937). Obviously, a sales and use tax are designed to achieve equality, but the Louisiana use tax did not actually achieve it. Although the rate of the two taxes was the same, the measure of the use tax was higher because it included labor and shop overhead. The measure of the sales tax did not. *Halliburton*, 373 U.S. at 67. The Court refused to sustain the use tax because "disparate treatment would be an incentive to locate within Louisiana". 373 U.S. at 72.

2. **Armco does not stand for the proposition that Washington's manufacturing and selling taxes are not compensating taxes.**

NCC's main challenge to the manufacturing tax is predicated on its contention that Washington's selling and manufacturing taxes are not compensating taxes. NCC Br. 14-15. NCC's compensating tax argument is based solely on the passage in *Armco*, 467 U.S. 638, 643 (1984), stating that manufacturing and wholesaling are not "substantially equivalent events". NCC Br. 14. From this phrase NCC concludes that no tax on manufacturing can ever compensate for a tax on selling, even if both taxes treat local business and interstate commerce in an equal manner.

NCC's argument is wrong for four reasons. First, the argument totally ignores the basis for all of the Court's compensating tax decisions, which is: are the taxes designed to achieve equality and do they actually result in equal treatment of local and interstate commerce? The Court has consistently applied these criteria in its decisions sustaining the compensating tax, as in *Silas Mason*, 300 U.S. 577 (1937), and its decisions striking down noncompensating taxes, as in *Halliburton*, 373 U.S. 64 (1963).

Even *Maryland v. Louisiana*, 451 U.S. 725 (1981), where the phrase "substantially equivalent event" first appears, was decided on this basis. In *Maryland v. Louisiana* the Court's decision was not based on some notion of the equivalency of events. It was based on the fact that Louisiana's taxing statutes were not designed to achieve equality. The Court stated:

> The two events [severance in Louisiana of non-OCS gas and use of OCS gas in Louisiana] are not comparable in the same fashion as a use tax complements a sales tax. In that case, a State is attempting to impose a tax on a substantially equivalent event to assure uniform treatment of goods and materials to be consumed in the State. No such equality exists in this instance. * * * [T]he pattern of credits and exemptions allowed under the Louisiana statute undeniably violates this principle of equality.

451 U.S. at 759. Thus, NCC's reliance on a substantially equivalent events test constitutes a radical departure from the compensating tax criteria evolved by the Court over the years.

The second flaw is that NCC misreads *Armco*. That case does not stand for the proposition that selling and manufacturing taxes can never be compensating taxes, any more than *Halliburton* stands for the proposition that sales and use taxes can never be compensating taxes. NCC takes the phrase "substantially equivalent events" out of context. What the Court actually said was:

> *Here, too,* manufacturing and wholesaling are not "substantially equivalent events" such that the heavy tax on in-state manufacturers can be paid to compensate for the admittedly lighter burden placed on wholesalers from out of State.

Armco, 467 U.S. at 643 (emphasis added). When the phrase is placed in context, it is apparent that the Court is speaking only of West Virginia's wholesaling and manufacturing taxes, not selling and manufacturing taxes in general.

The Court went on to analyze West Virginia's wholesaling and manufacturing taxes based on the traditional criteria for identifying a compensating tax. The Court concluded that the manufacturing and wholesaling taxes were not designed to achieve equality because of differences in the rate and measure of the two taxes. The Court's analysis continues:

> Manufacturing frequently entails selling in the State, but we cannot say which portion of the manufacturing tax is attributable to manufacturing, and which portion to sales. The fact that the manufacturing tax is not reduced when a West Virginia manufacturer sells its goods out of State, and that it is reduced when part of the manufacturing takes place out of State, makes clear that the manufacturing tax is just that, and not in part a proxy for the gross receipts tax imposed on Armco and other sellers from other States.

467 U.S. at 643 (footnotes omitted). Thus, it was the practical difference in the rate and measure of the two taxes that led the Court to rule that they were not compensating taxes. The Court did not base its analysis on the non-equivalence of manufacturing and selling.

It should also be noted that West Virginia's taxes did not actually result in equal treatment of local and interstate commerce. Since the measure of the manufacturing tax was reduced if part of the manufacturing took place outside the state, the possibility existed that the lower tax base could outweigh the effects of the higher manufacturing tax rate. In such cases, the West Virginia tax burden would actually be *reduced* by *increasing* the taxpayer's manufacturing activity in West Virginia.[8] Of course, this was also the basis for striking down

[8] For example, a product manufactured elsewhere and sold in West Virginia for \$1,000 was subject to wholesaling tax of \$2.70 (\$1,000 x .0027). If the same product was manufactured partially within and without West Vir-

the taxes in *Boston Stock Exchange*, 429 U.S. 318 (1977); *Maryland v. Louisiana;* and *Westinghouse*, 466 U.S. 388 (1984).

The third reason NCC's compensating tax argument is wrong is that it directly conflicts with *Hinson v. Lott*, 8 Wall. 148 (1869). The Court there held that taxes on a selling activity and a manufacturing activity were compensating taxes. In *Hinson* the plaintiff challenged an Alabama tax on the introduction of liquor into the state for sale. The tax was measured by the number of gallons imported and the rate of tax was 50¢ per gallon. On its face this tax appears discriminatory because it was imposed only on liquor brought into Alabama from other states. However, the Court sustained the tax because Alabama also imposed a tax on liquor manufactured in the state, at precisely the same rate and measure as the challenged tax — 50¢ per gallon. When the two taxes were considered together, the Court concluded that the challenged tax was non-discriminatory because "no greater tax is laid on liquors brought into the State than on those manufactured within it." 8 Wall. at 153.

A flat rule that manufacturing and selling can never be substantially equivalent events would be completely inconsistent with *Hinson*. The relevance and importance of *Hinson* stems not just from its holding, but also from the fact that it was cited as controlling in *Silas Mason*, 300 U.S. at 585. Thus, in what generally is viewed as the Court's most important compensating tax decision, a tax on manufacturing and a tax upon importation for sale were clearly treated as compensating taxes.

The fourth reason NCC's argument is wrong is that its reading of *Armco* results in an essentially meaningless test.[9] NCC claims that taxes must be on "substantially equivalent events" to have a valid compensating tax. NCC Br. 15 n. 17. Yet NCC does not explain how such a test is to be applied, short of weighing the equivalence of various activities on some metaphysical scale.

ginia and if the manufacturing tax base was reduced from \$1,000 to \$250, then the manufacturing tax on the same product sold in West Virginia would be \$2.20 (\$250 x .0088).

[9] "[T]he formal differences in the legal incidences of the two taxes do not provide an analytically defensible ground of distinction." Hellerstein, *supra* p. 22 n. 7, at 432.

The problem with NCC's proposed test can be demonstrated by comparing the equivalence of the activities of sales and use with the equivalence of the activities of manufacturing and selling. *Silas Mason* establishes that a use tax on the privilege of use can be a valid compensating tax for a retail sales tax imposed on the activity of purchasing at retail. Thus, even NCC must concede that sales and use taxes are imposed on substantially equivalent events.

However, no logical distinction exists between the substantial equivalence of the activities of sales and use and the substantial equivalence of the activities of manufacturing and selling. Sales and use are separate and distinct activities. There can be use without sale, but there cannot be a retail sale without use. Similarly, manufacturing and selling are separate activities. There can be manufacturing without a sale, but there cannot be a sale of manufactured articles without manufacturing. Indeed, the Court recognized the similarity in these two sets of relationships in *Silas Mason* where the Court cited *Hinson* to support its conclusion that the use tax was a valid compensating tax for the sales tax. *Silas Mason*, 300 U.S. at 585.

NCC's substantially equivalent events test does not withstand analysis. It is inconsistent with compensating tax criteria laid down by the Court. The test is based on a misreading of *Armco* and is directly contrary to the Court's holding in *Hinson*. Finally, the test is of no analytical value whatsoever.

3. The selling and manufacturing taxes are designed to achieve equality and actually result in equal treatment of local and interstate commerce.

Washington's manufacturing tax meets the compensating tax criteria laid down by the Court. First, the selling and manufacturing taxes are designed to achieve equality. Unlike the West Virginia wholesaling and manufacturing taxes in *Armco*, 467 U.S. 638 (1984), Washington's selling and manufacturing taxes have the same rate and measure. They are designed to tax equally all goods sold or manufactured in Washington.[10]

[10]The complementary operation of the two taxes is a neutral consideration for in-state manufacturers deciding where to market their products, and thus in contrast to those state regulatory measures the Court has declared "off-limits" under the Commerce Clause. *See, e.g., New England Power Co. v. New Hampshire*, 455 U.S. 331, 339 (1982).

The Washington Supreme Court recognized this design as early as 1954 when it rejected the precise claim made by NCC, that the manufacturing tax was discriminatory because only interstate manufacturers pay it. The Washington Supreme Court stated:

> [A]s a purely practical matter in terms of a program envisaging imposition of the business and occupation tax upon only one taxable activity, it may be said that a local manufacturer, selling in intrastate commerce, pays a business and occupation tax upon its wholesaling activity.

Crown Zellerbach Corp., 45 Wn.2d 749, 759, 278 P.2d 305 (1954).[11]

Second, the selling and manufacturing taxes actually result in equal treatment of local and interstate taxpayers similarly situated. NCC demonstrates this fact perfectly. It pays an identical tax of $4.40 ($1,000 x .0044) whether it manufactures and sells $1,000 of goods in Washington; sells goods in Washington manufactured elsewhere; or sells elsewhere goods produced in Washington.

The selling and manufacturing taxes have precisely the same economic effect as the compensating taxes in *Hinson*, 8 Wall. 148 (1869) and *Silas Mason*, 300 U.S. 577 (1937). Washington's manufacturing tax, when considered with the selling tax, does not provide a direct commercial advantage to local business. The two taxes treat local and interstate commerce in an equal manner, allowing for tax neutral decision-making. Thus, the manufacturing tax does not discriminate against interstate commerce.

D. Washington's Manufacturing Tax, a Valid Compensating Tax, Is Not Rendered Discriminatory by the Concept of Internal Consistency.

[11]NCC cites *Columbia Steel Co. v. State*, 30 Wn.2d 658, 192 P.2d 976 (1948) to create the impression that Washington, itself, does not view the manufacturing and selling taxes as compensating taxes. NCC Br. 15 n. 17. In *Columbia Steel* the court did not even address the question of whether the manufacturing and selling taxes should be considered together. In *Crown Zellerbach* the court considered the two taxes together and concluded that they were complementary. It is this difference in analysis that distinguishes *Columbia Steel* and *Crown Zellerbach*.

NCC raises one additional argument in relation to the compensating tax question. According to NCC: "Even if Washington's taxes are viewed as 'compensatory,' they discriminate against interstate commerce." NCC Br. 12. NCC's argument is based on the reference to internal consistency in *Armco*, 467 U.S. 638, 644 (1984). NCC Br. 12-13 n. 14.[12] We begin our analysis by showing that NCC has taken the internal consistency phrase out of context. The concept has never been used to strike down an otherwise valid compensating tax.

1. **Armco did not apply the concept of internal consistency to strike down an otherwise valid compensating tax.**

The Court in *Armco*, 467 U.S. 638 (1984) did not strike down West Virginia's wholesaling tax on the basis of "internal consistency". Once again, NCC has taken a phrase from *Armco* out of context. The Court's mention of internal consistency was dicta, the Court having concluded already that West Virginia's wholesaling tax was discriminatory because it was not a compensating tax. Despite this fact West Virginia argued that Armco be required to prove actual discriminatory impact. 467 U.S. at 644. The Court rejected this argument stating:

> This is not the test. In *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159, 169 (1983), the Court noted that a tax must have "what might be called internal consistency — that is the [tax] must be such that, if applied by every jurisdiction," there would be no impermissible interference with free trade.

467 U.S. at 644. The Court carefully limited its discussion in *Armco* to situations where a tax is *facially discriminatory*:

> In [*Container*], the Court was discussing the requirement that a tax be fairly apportioned to reflect the business conducted in the State. *A similar rule applies where the allegation is that a tax on its face discriminates against interstate commerce.*

467 U.S. at 644 (emphasis added).

[12] Even if the Court in *Armco* intended to apply internal consistency to a compensating tax, its application would be limited to Washington's manufacturing tax. It would not apply to Washington's selling tax which is imposed on *all* sales in Washington. Thus, in *Armco* when the Court struck down the wholesaling tax there was no indication that the manufacturing tax which was imposed on *all* West Virginia manufacturers was similarly invalid.

Obviously, the reference to internal consistency does not apply to a valid compensating tax. By definition a compensating tax does not discriminate on its face against interstate commerce because local and interstate businesses are treated in an equal manner.

2. **NCC's internal consistency test conflicts with the Court's compensating tax decisions.**

NCC's argument is wrong because it would result in striking down compensating taxes specifically approved by the Court. Under NCC's test the challenged taxes of State A are projected into State B. NCC claims that even valid compensating taxes are discriminatory if interstate commerce pays two taxes *e.g.*, one in State A and one in State B, and local business pays one tax.

Under this test the compensating taxes in both *Hinson*, 8 Wall. 148 (1869) and *Southern Pacific Co. v. Gallagher*, 306 U.S. 161 (1939) would be adjudged discriminatory. If the Alabama taxes approved in *Hinson* were projected into another state, *e.g.*, State A, the result would be as follows: An interstate business pays two taxes, the State A tax on manufacturing liquor and the Alabama tax on introducing liquor into the state for sale. On the other hand, a local business manufacturing and selling liquor in Alabama pays one tax, the Alabama manufacturing tax. The result is the same for the situation addressed in *Southern Pacific* where the Court sustained the imposition of California's tax based on its earlier decision in *Silas Mason*, 300 U.S. 577 (1937). In both *Hinson* and *Southern Pacific* the Court ruled that the compensating taxes at issue were nondiscriminatory. NCC's internal consistency test is in direct conflict with these decisions.

This conflict is not coincidental. The Court has specifically refused to apply an internal consistency requirement to otherwise valid compensating taxes.

The question of internal consistency first arose in *Silas Mason*. The sales and use tax at issue there is one of the few compensating taxes approved by the Court that could pass NCC's internal consistency test. This is because Washington provided a credit against Washington use tax for sales tax paid in other states. 300 U.S. at 580-81. Thus, if Washington's sales and use taxes were projected into another state, *e.g.*, State A,

both interstate and local business would pay one tax. Interstate commerce pays sales tax in State A but no Washington use tax is due because of the credit. Similarly, a local business both buying and using goods in Washington pays one tax, Washington's sales tax. While the credit made Washington's tax internally consistent, in the sense NCC argues, the Court specifically refrained from ruling on whether the credit was constitutionally required. 300 U.S. at 587.

In *Southern Pacific* the Court sustained California's use tax even though it *lacked* internal consistency, owing to the absence of the credit provision found in the Washington system. The Court specifically refused to apply an internal consistency test by projecting California's taxes into another state because:

> It will be time enough to resolve that argument "when a taxpayer paying in the state of origin is compelled to pay again in the state of destination."[12]
>
> [12]*Henneford v. Silas Mason Co.*, 300 U.S. 577, 587.

306 U.S. at 172.

In *Williams v. Vermont*, 472 U.S. ___, 105 S.Ct. 2465, 2471 (1985) the Court reaffirmed its ruling in *Southern Pacific* and again refused to consider a Commerce Clause discrimination claim based on the absence of the credit, which was really an internal consistency claim. Thus, the Court has never invalidated an otherwise valid compensating tax based on internal consistency. NCC's argument that the manufacturing tax should be struck down even though it is a valid compensating tax should be similarly rejected.

Finally, *Southern Pacific* puts into focus what is really at stake in NCC's efforts to use the concept of internal consistency to strike down an otherwise valid compensating tax. To have granted the taxpayer relief in *Southern Pacific* would have amounted to granting it preferential treatment over local taxpayers, for California relieved local taxpayers of a use tax only if a sales tax had actually been paid on the same item. The taxpayer in *Southern Pacific*, however, was claiming that it should be relieved of the use tax even if it had paid no sales tax to California *or to any other state* on that same item.

Here too, NCC is asking that Washington be required to provide relief from a compensating tax in order to offset taxes which it *in fact does not pay*, while local taxpayers obtain

tain relief from that same tax only as an offset for taxes which they *in fact do pay*, and that, as in *Southern Pacific*, amounts to a claim for preferential treatment.

III. WASHINGTON'S SELLING AND MANUFACTURING TAXES ARE PROPERLY APPORTIONED ACCORDING TO THE COURT'S PRIOR HOLDINGS.

The Taxpayers also claim that Washington's selling and manufacturing taxes violate the second prong of the *Complete Auto* test, the requirement that a tax be fairly apportioned. TPI Br. 17; NCC Br. 15-17.[13] We begin by correcting NCC's mischaracterization of the measure of the selling and manufacturing taxes. We will then review the decisions of the Court which uphold the apportionment of these taxes and show that no multiple burden exists in this case.

NCC's apportionment argument is based on its contention that "Washington's manufacturing tax and selling taxes are based on 100% of the gross receipts from [its] activities in Washington and other states" while other states can and do impose taxes on these same receipts. NCC Br. 17. NCC's description of the measure or base of Washington's selling and manufacturing taxes is incorrect.

The record proves that Washington does not base its taxes on "100% of the gross receipts" from NCC's activities in Washington and all other jurisdictions. In 1983 NCC's gross receipts from sales alone were approximately $1.552 *billion*. J.A. 181 ¶ 13. Washington's selling tax was based on approximately $110 *million*, which represents NCC's "gross proceeds of sales" in Washington that year.[14] J.A. 181 ¶ 13. The manu-

[13]While TPI challenges the apportionment of Washington's wholesaling tax, its only argument is subsumed in its claim that the tax is not fairly related to the services provided by the state under the fourth prong of the *Complete Auto* test. We address this argument *infra*, section IV(B), pp. 42-44.

[14]Only a small part of the $110 million of Washington sales involved goods manufactured in another state. NCC's Washington sales of goods manufactured elsewhere ranged from $19.9 to $32 million between 1981 and 1984. J.A. 180 ¶ 9. In contrast, NCC's Washington sales of goods manufactured in the state ranged from $71.4 to $78.5 million between 1981 and 1984. J.A. 181 ¶ 11.

facturing tax was based on approximately $18.7 *million*,[15] which represents the "value of products" NCC manufactured in Washington and sold elsewhere, as determined by their selling price. J.A. 180 ¶ 10. Thus, NCC's Washington tax was actually based on approximately $128.7 *million* out of total gross sales receipts of approximately $1.552 *billion*.

We now turn to the Court's decisions pertaining to the measure of gross receipts taxes. The Court has consistently sustained gross receipts taxes that have been both imposed on a local activity or transaction and measured by the value of that activity or transaction.

Selling and manufacturing are both local privileges granted by the state, and another state cannot tax the privileges of engaging in selling and manufacturing activities in Washington. The Court has ruled that the delivery state is the only state that can tax the sale of goods, striking down sales taxes imposed by states other than the delivery state. *See Evco v. Jones*, 409 U.S. 91 (1972) and *J. D. Adams Manufacturing Co. v. Storen*, 304 U.S. 307 (1938). The same is true of manufacturing. Because the manufacturing activity takes place here, Washington is the only state that can tax that activity. In this respect manufacturing is similar to the severance discussed in *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 617 (1981) where the Court stated:

> Nor is there any question here regarding apportionment or potential multiple taxation, for as the state court observed, "*the severance can occur in no other state" and "no other state can tax the severance*." (Emphasis added.)

It is also well established that the gross proceeds of sales provide a proper value for the selling and manufacturing activities that take place in the state. In *Standard Pressed Steel*, 419 U.S. 560, 564 (1975) the Court stated that Washington's selling tax measured by the gross proceeds of sales was "apportioned exactly to the activities taxed". The Court cited this statement from *Standard Pressed Steel* with approval in *Moorman Manufacturing Co. v. Bair*, 437 U.S. 267, 280

[15]The parties' stipulation provides that NCC's annual out-of-state sales of products manufactured in Washington ranged from $11.3 to $18.7 million between 1981 and 1984. The record does not reflect a specific amount for the year 1983. J.A. 180 ¶ 10.

(1978). More recently, the imposition of Washington's selling tax, measured by the gross proceeds of sales, was approved in *Chicago Bridge & Iron*, 98 Wn.2d 814, 659 P.2d 463 (1983), *appeal dism'd*, 464 U.S. 1013 (1983). The Court has also approved manufacturing taxes measured by the value of the products, as determined by the selling price of the goods. *See American Manufacturing Co. v. St. Louis*, 250 U.S. 459, 462-63 (1919); *Western Live Stock v. Bureau of Revenue*, 303 U.S. 250, 258 (1938). As the Court stated in *Freeman v. Hewit*, 329 U.S. 249, 258 (1946): "It has long been settled that a state can levy [a manufacturing] occupation tax graduated according to the volume of manufacture."

These decisions firmly establish that the selling and manufacturing taxes are fairly apportioned. The only contrary authority cited by NCC is *Gwin, White & Prince, Inc. v. Henneford*, 305 U.S. 434 (1939). The tax in *Gwin, White* was different from the selling and manufacturing taxes. The tax was imposed on "engaging * * * in any business activity," not a local activity like selling or manufacturing, and the tax was measured by the "gross income of the business" not the value of the local activity. 305 U.S. at 435.

The Court has recognized that the analysis in *Gwin, White* does not apply to selling and manufacturing taxes like the ones at issue here. In *Standard Pressed Steel* the Court specifically distinguished *Gwin, White* in reaching its conclusion that the selling tax was "apportioned exactly to the activities taxed". 419 U.S. at 564. In *Gwin, White*, itself, the Court distinguished and approved the imposition of the manufacturing tax involved in *American Manufacturing*, 305 U.S. at 440.

The fact that a state imposes a tax on a local activity, measured by the value of that activity, does not create a multiple burden nor require additional apportionment. Incorporating the position of the *amicus curiae* Amcord, et al., NCC also argues that the use of the same gross receipts, employed to measure Washington's selling and manufacturing taxes, in the income tax base of some other state creates a prohibited multiple tax burden and thereby requires an additional apportionment of Washington's tax. The Court rejected this same contention in *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207 (1980), where the taxpayer argued it was subject to such a multiple burden because other states im-

posed severance taxes on the extraction of oil and gas. The Court ruled that this did not constitute a multiple burden because:

> Severance taxes * * * are directed at the gross value of the mineral extracted or the quantity of production rather than the net income derived from the production activities. * * * The Wisconsin Supreme Court therefore properly concluded that "[t]he fact that the producing states may impose * * * severance taxes which have been held to be occupation taxes or property taxes does not render unfair or unconstitutional Wisconsin's efforts to reach a proportionate share of the taxpayer's income." 90 Wis.2d at 731, 281 N.W.2d at 110-11.

477 U.S. at 228-29 n. 12 (citations omitted).

Most recently, *Armco*, 467 U.S. 638, 645 (1984) indicates that there would be no constitutional infirmity if Ohio imposed a manufacturing tax and West Virginia imposed a selling tax. Yet clearly that situation would also involve the possibility of overlapping tax bases.

It is also important to remember that formulary apportionment of gross receipts taxes such as the selling and manufacturing taxes does not solve the problem of overlapping tax bases. Even if all states were required to use formulary apportionment there could still be overlapping tax bases unless the Court specified a particular type of formula, *e.g.*, three factors. This was precisely the problem before the Court in *Moorman*, 437 U.S. 267 (1978). Since Iowa used a one factor formula to apportion its income tax, there was a possibility of overlapping tax bases with other states that used three factor formulas to apportion their income taxes. The Court recognized that to cure this problem "would require national uniform rules for the division of income." 437 U.S. at 279. The Court refused to take this step because Congress was better equipped to give due consideration to the interests of the various states. 437 U.S. at 280.

IV. THE SELLING TAX IS IMPOSED ON A SUFFICIENT NEXUS AND IS FAIRLY RELATED TO SERVICES PROVIDED.

TPI raises two Commerce and Due Process Clause issues

of its own.[16] First and foremost, TPI claims that there is an insufficient nexus between its activities and the State of Washington. TPI Br. 10-13. TPI chiefly argues that the activities performed on its behalf in Washington constitute mere solicitation of sales which is insufficient to create a tax nexus. Second, TPI claims that imposition on it of the same tax rate and measure as on in-state taxpayers engaged in more activities means that the tax is not rationally or fairly related to values or services in Washington. TPI Br. 17-19.

The real nexus issue, however, is the same as it has long been: has the taxpayer "established that such services as were rendered * * * [through in-state activity] were not decisive factors in establishing and holding this market"? *General Motors*, 377 U.S. 436, 448 (1964), quoting *Norton Co. v. Department of Revenue of Illinois*, 340 U.S. 534, 538 (1951). *See Standard Pressed Steel*, 419 U.S. 560, 562 (have the in-state activities "made possible the realization and continuance of valuable contractual relations" between the taxpayer and others?). This is the decisive issue, regardless of whether the local activities consist only of "solicitation" or whether the agents performing them are employees or independent contractors. We will show that TPI has not carried its burden under this test.

TPI's second claim is refuted by the very case it cites.

A. The Solicitation and Other Local Activities Performed on TPI's Behalf Create a Sufficient Nexus for a Gross Receipts Tax.

1. Local solicitation alone creates nexus.

Contrary to TPI's first claim, in-state solicitation by state residents creates a sufficient tax nexus.

This is perhaps best illustrated by *Northwestern States Portland Cement Co. v. Minnesota*, 358 U.S. 450 (1959). The cases consolidated there each involved a taxpayer whose in-state activities consisted of regular solicitation of orders,

[16] Even if the Court somehow rules that the selling tax is discriminatory against NCC due to the multiple activities exemption, these TPI issues will remain. TPI incurs only selling tax liability because it *engages only in selling* and does no manufacturing, not because of the multiple activities exemption. *See supra* pp. 4, 20-21. Thus, TPI cannot conceivably prevail on its discrimination claim.

through one or more employee salesmen operating from an in-state office. Orders were transmitted to and shipped from an out-of-state facility. 358 U.S. at 454-56. This Court held that net income from the interstate operations was subject to state taxation which was not discriminatory and was properly apportioned to local activities "forming sufficient nexus". 358 U.S. at 452. The Court concluded that the taxpayers' in-state activities, constituting "substantial income-producing activity in the taxing States", formed such a "nexus." 358 U.S. at 465. In short, *Northwestern States* holds that solicitation alone can create nexus.[17]

This contradicts TPI's claim that "solicitation of sales" is insufficient. TPI Br. 11. TPI cites *Robbins v. Shelby County Taxing District*, 120 U.S. 489 (1887), but the Court long ago noted that the *Robbins* rule "has been narrowly limited to fixed-sum license taxes imposed on the business of soliciting orders for the purchase of goods to be shipped interstate". *McGoldrick v. Berwind-White Coal Mining Co.*, 309 U.S. 33, 57 (1940). Here, in contrast, the B&O tax is imposed on the privilege of making sales in Washington, measured by the gross proceeds of those sales. Wash. Rev. Code §§ 82.04.220 and 82.04.270, TPI J.S. G-2-4. Moreover, even a (reasonable) license tax would likely survive now under the *Complete Auto* test.[18]

[17]*Northwestern States* prompted enactment of Public Law 86-272, 15 U.S.C. §§ 381 *et seq.*, TPI J.S. G-1-2. *Cf.* TPI Br. A-1-5. The effect of that act is not among the Questions Presented, TPI J.S. i-ii, and thus is not before the Court. In any event, that act is inapplicable, according to the Washington Supreme Court's unchallenged holding, because the "B&O tax is not a net income tax". TPI J.S. A-9; TPI Br. 13 n. 12. Even if it did apply, the representatives' activities here go far beyond the mere "solicitation of orders" which is tax-exempt under that act, as will be reiterated momentarily. There is no basis for this Court to expand that act to these other activities, and to a gross receipts tax, when Congress itself has not seen fit to do so. The real significance of the act here is to show that Congress regarded "solicitation" by "independent contractors" as constitutionally creating a tax nexus, which directly refutes TPI's chief contention. Otherwise, there would have been no reason for the act's restrictions.

[18]*Robbins* is also inapposite because it involved non-resident solicitors and thus only barred " 'taxes upon persons passing through the state, or coming into it merely for a temporary purpose' such as itinerant drummers." *Northwestern States*, 358 U.S. at 458. Here, of course, TPI's representatives are Washington residents.

The *Northwestern States* rule that local solicitation by itself can create sufficient nexus, unlike the contrary rule urged by TPI, makes sense. There is no conceivable reason to deny recognition of nexus based upon the very local activities directly giving rise to the in-state sales.

2. **All of the local activities here create nexus.**

In focusing on solicitation, TPI dismisses the numerous other functions which the courts below found were also performed on TPI's behalf by its local representatives, as being "simply the sticks that make up the bundle of sales solicitation." TPI Br. 13 n. 11. This semantic exercise, if successful, would merely bring the case under *Northwestern States*, 358 U.S. 450 (1959). It cannot succeed, though, because the functions here go well beyond solicitation and thus also satisfy the nexus analysis in *Standard Pressed Steel*, 419 U.S. 560 (1975).

The taxpayer in *Standard Pressed Steel* was an out-of-state manufacturer with one employee, Martinson, operating from his home in Washington. His primary duty was to consult with the Boeing Company regarding its anticipated needs for aerospace fasteners and to follow up any difficulties in their use. Martinson was assisted by a group of the taxpayer's engineers who visited Boeing about three days every six weeks, for meetings he arranged. Orders and payments were sent directly to the taxpayer, not to Martinson. The State tax board found that Martinson's activities were necessary in furthering various aspects of the taxpayer's dealings with Boeing. 419 U.S. at 561. Answering the familiar question of "whether the state has given anything for which it can ask return," this Court unanimously said:

> [T]he question in the context of the present case verges on the frivolous. For [taxpayer's] employee, Martinson, with a full-time job within the State, made possible the realization and continuance of valuable contractual relations between [the taxpayer] and Boeing.

419 U.S. at 562. Thus, the Court found nexus for imposition of Washington's B&O tax based on market development and maintenance functions, without direct solicitation.

Corresponding nexus is present here. As in *Northwestern States*, TPI's representatives solicit orders and also regularly receive and transmit them to TPI. J.S. B-10 FF 9. Ashe &

Jones transmitted to TPI 55% of its total non-Wade Washington orders. J.A. 162. TPI's representatives also perform the market maintenance functions found sufficient in *Standard Pressed Steel*. They gather and regularly convey to TPI virtually all of TPI's necessary Washington market information. TPI J.S. B-9-10 FF 8. They develop and maintain TPI's Washington market, through "secondary calls" to generate future orders and other activities. TPI J.S. B-10 FF 10. In short, the activities of TPI's representatives involve *both* the solicitations of the salesmen in *Northwestern States* and the market development and maintenance functions of Martinson in *Standard Pressed Steel*.[19]

Whereas *Northwestern States* and *Standard Pressed Steel* support the finding of nexus here, the cases cited by TPI do not refute this conclusion. TPI relies particularly on *Norton*, 340 U.S. 534 (1951). TPI Br. 12–13. However, *Norton* actually found sufficient nexus in the receiving of orders. The Court held that

> the judgment attributing to the Chicago branch income from all sales that utilized it *either* in receiving the orders *or* distributing the goods was within the realm of permissible judgment. [The taxpayer] has not established that such services as were rendered by the Chicago office were not decisive factors in establishing and holding this market.

340 U.S. at 538 (emphases added). Thus, inasmuch as Ashe & Jones receives and transmits TPI orders, and given the other facts showing that its local services are decisive factors in holding the Washington market, *Norton* compels a nexus finding here.[20]

[19]Given these pervasive local activities undertaken for TPI, we do not rely, as TPI has inferred, on the lesser nexus standard that suffices to impose use tax collection duties. TPI J.S. 13-14. *Cf. National Geographic Society v. California Board of Equalization*, 430 U.S. 551 (1977).

[20]TPI's recitation of the acts it purportedly does not perform in Washington, TPI Br. 13, ignores the activities which its local representative *does* perform. For example, TPI claims that it maintained no local office or employees in Washington, TPI Br. 4–5, 13, notwithstanding that Ashe & Jones did so on its behalf. It admits to no local office providing services and handling complaints after a sale, TPI Br. 7, 13, disregarding the finding of fact that sales representatives participate in investigating and handling customer complaints, and the evidence that such contacts with Ashe & Jones occur about 10 to 12 times a year. TPI J.S. B-10 FF 10; J.A. 106. In any event, TPI's recitation completely ignores such significant Ashe & Jones activities as market information-gathering and "secondary calls" to generate future orders.

TPI may still argue that at least its Utility sales fall into the third category of nontaxable direct sales established in *Norton*, because Ashe & Jones generally did not transmit Utility orders. TPI Br. 13; TPI J.S. 15-16. Even this limited claim must fail in light of the evidence that virtually all of Ashe & Jones' local activities *except* order-taking were undertaken for both the DWV and Utility departments. *See, e.g.*, TPI J.S. B-9 FF 6; J.A. 48-49, 68, 84-90, 92, 99-103; TPI RP 275-79. In contrast, the majority in *Norton* concluded that the local office did *not* perform "service helpful to [the taxpayer's] competition for * * * trade" when the goods were ordered and shipped directly from the out-of-state office. 340 U.S. at 536. The *Norton* majority's observation that "no solicitors work the territory," 340 U.S. at 537, also distinguishes the present case, where active solicitors represent the Utility department, make secondary calls and solicit orders for that department, and receive commissions on Utility sales. TPI J.S. B-9 FF 6; TPI Br. 5; J.A. 95, 97, 102-03; TPI RP 245.

3. **The contractor status of TPI's agent does not affect nexus.**

TPI repeatedly paints the facts as if the local activities of Ashe & Jones were not even before the Court. If that were the case, there concededly would be little basis for a nexus finding under current law. On the other hand, if Ashe & Jones were TPI employees instead of contractors, nexus would be established beyond dispute by *Northwestern States*, 358 U.S. 450 (1959) and *Standard Pressed Steel*, 419 U.S. 560 (1975).

Two considerations compel a conclusion that the requisite nexus also exists here whether contractors or employees are involved. First, as a factual matter, there are no significant differences in how TPI's contractor representatives in Washington and employee representatives elsewhere solicit and process orders or otherwise "call on the trade". TPI J.S. B-11 FF 12.[21] Second, under this Court's decisions there also is no difference in the tax consequences.

[21]TPI has never disputed this fact, even now in reporting the state court's view of "the sales functions of Ashe & Jones as essentially identical to those of factory salesmen." TPI Br. 13 n. 11.

Scripto, Inc. v. Carson, 362 U.S. 207 (1960) so held, in finding sufficient nexus from the in-state activities of independent contractors to impose use tax collection liability on an out-of-state seller. The Court said that it does not matter for nexus purposes that a taxpayer's "salesmen" are not regular employees devoting full time to its service:

> [S]uch a fine distinction is without constitutional significance. The formal shift in the contractual tagging of the salesman as "independent" neither results in changing his local function of solicitation nor bears upon its effectiveness in securing a substantial flow of goods into [the taxing state].

362 U.S. at 211. As this Court further explained, "To permit such formal 'contractual shifts' to make a constitutional difference would open the gates to a stampede of tax avoidance." *Id.*

Since the "contractual tagging of the salesman" is without constitutional significance for a use tax, there is no reason for a different conclusion in the gross receipts context. TPI has never suggested why its own subjective decision to designate sales personnel as contractors rather than employees, without any difference in their functions, should mean different tax consequences. Obviously such an artificial distinction would lead to the same "stampede of tax avoidance" regardless of the type of tax.[22]

B. The Selling Tax Is Fairly Related to the Services Provided by the State of Washington.

TPI also argues that the selling tax is not fairly related to services provided by Washington, under the fourth prong of the *Complete Auto* test. This allegedly is because TPI utilized those services to a smaller extent than did a local manufacturer selling in state and it maintained "most (or at least much)" of its "values" in Texas. TPI Br. 18-20.

[22]The argument that such a distinction should make a difference in tax consequences was rejected in the gross receipts tax context by *Illinois Commercial Men's Association v. State Board of Equalization*, 34 Cal.3d 839, 671 P.2d 349, 196 Cal.Rptr. 198 (1983), *appeal dism'd*, 466 U.S. 933 (1984). Expressly following *Scripto*, the California Court held that "the circumstance that investigation and/or settlement services" on the taxpayers' behalf "were performed by independent contractors is of little constitutional significance. The undeniable fact is that they were acting as agents" of the taxpayers. 671 P.2d at 355.

This argument is directly refuted by the only case TPI cites in this regard, *Commonwealth Edison*, 453 U.S. 609 (1981). There the taxpayers' complaint was that "the *amount* the State receives in [severance] taxes far exceeds the *value* of the services provided to the coal mining industry." 453 U.S. at 621 (emphases by the Court). The Court responded that

> there is no requirement under the Due Process Clause that the amount of general revenue taxes collected from a particular activity must be reasonably related to the value of the services provided to the activity. Instead, our consistent rule has been:
>
> * * *
>
> "A tax is not an assessment of benefits. It is, as we have said, a means of distributing the burden of the cost of government. The only benefit to which the taxpayer is constitutionally entitled is that derived from his enjoyment of the privileges of living in an organized society, established and safeguarded by the devotion of taxes to public purposes. * * *"

453 U.S. at 622-23. According to the Court, this latitude afforded the states under the Due Process Clause is not "somehow divested by the Commerce Clause". 453 U.S. at 623.

The Court went on to state this test:

> The relevant inquiry under the fourth prong of the *Complete Auto Transit* test is not * * * the *amount* of the tax or the *value* of the benefits allegedly bestowed as measured by the costs the State incurs on account of the taxpayer's activities. Rather, the test is closely connected to the first prong of the *Complete Auto Transit* test. Under this threshold test, the interstate business must have a substantial nexus with the State before *any* tax may be levied on it. * * * Beyond that threshold requirement, the fourth prong of the *Complete Auto Transit* test imposes the additional limitation that the *measure* of the tax must be reasonably related to the extent of the contact * * * *

453 U.S. at 625-26 (footnotes and citation omitted; emphases by the Court). There, this test was met. "Because it is measured as a percentage of the value of the coal taken, the Montana tax is in 'proper proportion' to [taxpayers'] activities within the State". 453 U.S. at 626.

Washington's tax also manifestly passes this test. As shown above, TPI's business has a substantial nexus with Washington. The measure of the tax is related exactly to the extent of TPI's Washington contact, being a percentage of TPI's gross receipts from Washington sales. *See Standard Pressed Steel*, 419 U.S. 560, 562, 564.

V. IF WASHINGTON'S TAX SYSTEM WERE TO BE INVALIDATED UNDER THE COMMERCE CLAUSE, THE ISSUE OF REMEDY REMAINS.

The decisions reached by the court below upholding Washington's multiple activities exemption are consistent with this Court's opinion in *Armco*, 467 U.S. 638 (1984), which is itself consonant with the Court's earlier decisions. However, the magnitude of tax refund claims requires the State to address remedies in the event that this Court might invalidate Washington's B&O tax, either as to out-of-state manufacturers or Washington manufacturers selling outside the state.[23]

A decision invalidating the tax would narrow the latitude the Constitution affords states fashioning their tax systems and would represent a significant departure from the Court's earlier Commerce Clause decisions. Were such a decision rendered, it should be applied prospectively, because it would expressly or by clear implication overrule "clear past precedent" on which the state has relied for the imposition of the tax. *Chevron Oil Co. v. Huson*, 404 U.S. 97, 106-07 (1971).

A. Any Decision Adverse to the State Should Be Given Prospective Effect.

A decision overturning Washington's manufacturing tax would rest either on a holding that manufacturing and selling taxes can *never* be deemed compensating taxes or on some other constitutional basis foreshadowed no earlier than the Court's opinion in *Armco*, 467 U.S. 638 (1984). A holding on the former grounds would represent a rejection of the Court's longstanding decision in *Hinson*, 8 Wall. 148 (1869) to which no reference was made in *Armco*. A decision invalidating Washington's manufacturing tax on any of the other grounds

[23]As NCC has pointed out, NCC J.S. 4, potential tax refunds just for the period through December 31, 1984 approximate $423 million.

advanced here by The Taxpayers would not have been clearly signaled by any of the Court's opinions preceding *Armco*.[24]

The tests in *Chevron Oil* for prospective or retrospective application of decisions require the Court to determine whether retrospective application of a rule announced by the decision will promote or interfere with the constitutional interests bound up in the holding. In this regard, the Court has inquired whether retroactive application of its decision would, in actuality, advance the constitutional interests involved. *See, e.g., Lemon v. Kurtzman*, 411 U.S. 192 (1973) (*Lemon II*).

A decision adverse to the state in this case might prohibit the state from imposing its present tax system or require a particular form of apportioned taxation. Either result would not of itself demonstrate that its retrospective application would advance these Commerce Clause interests beyond what the prospective prohibition of the earlier system of taxation can accomplish. A contention that refunds for prior years will further the Commerce Clause's interest in preserving free trade in the future is too speculative. *Cf. Johnson v. New Jersey*, 384 U.S. 719, 728-29 (1966). Moreover, the Court should not require such a refund where The Taxpayers have failed to demonstrate loss from the kind of multiple taxation the Court has heretofore prohibited.

Finally, under the tests laid down in *Chevron Oil* the Court looks at the likelihood of substantial, inequitable results or hardship that may flow from a decision operating retroactively. While the Court may assess the conflicting interests of the parties, significant weight is accorded the good faith reliance of state and local governments on established law, where fiscal matters are involved and there is a need to prevent disruption in the public sector with respect to transactions already concluded. *See, e.g., Cipriano v. Houma*, 395 U.S. 701 (1969).

Washington's selling tax has been continually sustained

[24]Consistent with the implications in their brief, The Taxpayers have previously argued in this litigation that the Court's opinions in *Maryland v. Louisiana*, 451 U.S. 725 (1981) and *Container Corp. of America v. Franchise Tax Board*, 463 U.S. 159 (1983) have clearly imperiled Washington's taxes. Only after the Court's decision in *Armco* were this challenge and those of other taxpayers mounted, a fact which sufficiently belies the contention.

by this Court.[25] There has been reliance upon the state's manufacturing tax both by public officials and objectively speaking, by taxpayers themselves, following decisions upholding its validity by Washington's highest court, decisions from which no further appeal was taken or heard.[26]

Hardships that would be entailed by requiring refunds of revenues collected and expended as part of the state's enacted budgets over a period of more than six years are a matter of record.[27] As these potential dislocations are weighed, it must be noted once again that The Taxpayers have failed to demonstrate in the record any particularized injury resulting from an aggregation of those types of taxes which the Court has recognized as creating a burden of multiple taxation.

If any decision invalidating Washington's tax is entered, it should, therefore, have only prospective application.

B. This Court's Decisions Prompt Remand to the Court Below for Consideration of Further Issues of Remedy, if the Court Determines Retrospective Effect Is to Be Given to Its Decision.

If this Court were to decide that some retrospective application of a decision adverse to the state would be warranted, the nature of the remedy to be afforded requires resolution of questions which are not before the Court on this appeal. The Taxpayers would not unqualifiedly be entitled to refund simply by reason of a decision invalidating part or all of the tax in issue here.

In its first session following the Court's decision in *Armco*, 467 U.S. 638 (1984), the Washington legislature enacted a manufacturing business and occupation tax credit for Washington businesses paying gross receipts taxes to other jurisdictions.[28]

The credit, made provisional upon any decision invalidating Washington's tax, was adopted in the uncertain environment immediately following *Armco* in a straightforward effort by the state to anticipate possible ramifications to Washington's tax system of the Court's discussion of internal consistency. Issues of the credit's application, including any contentions about the validity of the credit itself and The Taxpayers' entitlement to the benefit, are not before this Court and remain to be resolved.

Washington law also contains a comprehensive severability provision as part of its revenue laws.[29] This statute would become relevant, should the 1985 credit provision for any reason be found infirm.

The issues arising out of these related features in Washington law were not reached by the court below. They demonstrate the "intertwined" questions of federal constitutional and state law that have prompted the remand of this Court's decisions for subsequent determinations about the application of exemptions or extensions of taxes. *Bacchus*, 468 U.S. 263, 277 (1984); *Hooper v. Bernalillo County Assessor*, 472 U.S. ____, 105 S.Ct. 2862, 2869 (1985). In these situations the courts below have been left with the determination whether an exemption is to be extended or a tax applied.

[25] *Standard Pressed Steel*, 419 U.S. 560 (1970); *General Motors*, 377 U.S. 436 (1964). *See also* the dismissal of an appeal challenging the tax, *Chicago Bridge & Iron*, 464 U.S. 1013 (1983).

[26] *See Crown Zellerbach*, 45 Wn.2d 749, 278 P.2d 305 (1954). *See also Crown Zellerbach Corp. v. State*, 53 Wn.2d 813, 328 P.2d 884 (1958), *appeal dism'd*, 359 U.S. 531 (1959). As the Court acknowledged in *Armco*, a case raising an issue similar to that presented here by Washington's manufacturing tax exemption was dismissed in 1982 for want of a substantial federal question. *Columbia Gas Transmission Corp. v. Rose*, 459 U.S. 807 (1982).

[27] *See* Affidavit of Daniel Keller, J.A. 210, 215. Based on projections for the state's current 1985-87 biennium, refunds of this magnitude would require an 18% reduction in all programs financed through the state's general fund.

[28] Wash. Rev. Code § 82.04.440, 1985 Wash. Laws ch. 190, § 1. The amended section is reproduced in the Appendix.

[29] Wash. Rev. Code § 82.98.030 is strikingly similar to that found in the savings clause in New York law which occasioned the Court to remand its opinion in *Boston Stock Exchange*, 429 U.S. 318, 337 n. 15 (1977) to the lower court for determination of its application. The text of this section is set out in the Appendix.

CONCLUSION

The judgment of the Washington Supreme Court should be affirmed. However, if the Court overrules some of its prior decisions and invalidates Washington's tax system, the Court should apply its decision prospectively. To the extent the decision is given retrospective application, the case should be remanded for the resolution of questions relating to The Taxpayers' remedy, not before the Court on this appeal.

DATED this 26th day of December, 1986.

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Appendix

Wash. Rev. Code § 82.04.440 Persons taxable on multiple activities. (1) Except as provided in subsections (2) and (3) of this section, every person engaged in activities which are within the purview of the provisions of two or more of sections RCW 82.04.230 to 82.04.290, inclusive, shall be taxable under each paragraph applicable to the activities engaged in.

(2) Persons taxable under RCW 82.04.250 or 82.04.270 shall not be taxable under RCW 82.04.230, 82.04.240, or subsection (2), (3), (4), (5), or (7) of RCW 82.04.260 with respect to extracting or manufacturing of the products so sold.

(3) Persons taxable under RCW 82.04.240 or 82.04.260 subsection (4) shall not be taxable under RCW 82.04.230 with respect to extracting the ingredients of the products so manufactured.

(4)(a) If it is determined by a court of competent jurisdiction, in a judgment not subject to review, that subsection (2) of this section results in an unconstitutional discrimination against interstate or foreign commerce, and that relief is appropriate for any tax reporting periods either before or after April 30, 1985, it is the intent of the legislature that the credit provided in (b) of this subsection shall be applied to such reporting periods and that relief for such periods be limited to the granting of such credit. It is further the intent of the legislature that such credit shall be applicable only under the conditions and to the extent provided in this subsection (4).

(b) As provided in (a) of this subsection, a person taxable under RCW 82.04.230, 82.04.240, or subsection (2), (3), (4), (5), or (7) of RCW 82.04.260 with respect to extracting or manufacturing products in this state shall be allowed a credit against those taxes for any gross receipts taxes paid to another state with respect to the sales of the products so extracted or manufactured in this state. The amount of the credit shall not exceed the tax liability arising under this chapter with respect to the extraction or manufacturing of those products.

(c) For the purpose of this subsection, "gross receipts tax" means a tax:

(i) Which is imposed on or measured by the gross volume of business, in terms of gross receipts or in other terms, and in

the determination of which the deductions allowed would not constitute the tax an income tax or value added tax; and

(ii) Which is also not, pursuant to law or custom, separately stated from the sales price.

(d) For the purpose of this subsection, "state" means state of the United States, any political subdivision thereof, or the District of Columbia, and any foreign country or political subdivision thereof. [As amended by 1985 Wash. Laws ch. 190, § 1.]

Wash. Rev. Code § 82.98.030 Invalidity of part of title not to affect remainder. If any chapter, section, subdivision of a section, paragraph, sentence, clause or word of [Title 82 RCW] for any reason shall be adjudged invalid, such judgment shall not affect, impair or invalidate the remainder of this title but shall be confined in its operation to the chapter, section, subdivision of a section, paragraph, sentence, clause or word of the title directly involved in the controversy in which such judgment shall have been rendered. If any tax imposed under this title shall be adjudged invalid as to any person, corporation, association or class of persons, corporations or associations included within the scope of the general language of this title such invalidity shall not affect the liability of any person, corporation, association or class or persons, corporations, or associations as to which such tax has not been adjudged invalid. It is hereby expressly declared that had any chapter, section, subdivision of a section, paragraph, sentence, clause, word or any person, corporation, association or class of persons, corporations or associations as to which this title is declared invalid been eliminated from the title at the time the same was considered the title would have nevertheless been enacted with such portions eliminated. This section shall not apply to chapter 82.44 RCW.